IRVIN CORLEY, JR.
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# City of Detroit

CITY COUNCIL

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ANNE MARIE LANGAN
DEPUTY DIRECTOR
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TO: COUNCIL MEMBERS

FROM: Irvin Corley, Jr., Director IC Jr.

DATE: June 3, 2008

RE: Response to Mayor Kilpatrick's Veto Message for Council's Actions On the Proposed 2008-09 Budget

Honorable Council members, as your fiscal advisor, I feel compelled to respond to the Mayor's partial veto of your actions on his proposed 2008-09 General Fund budget. I will not comment on the Mayor's full veto of Council's changes to the proposed Community Development Block Grant 2008-09 budget, as I suspect the City Planning Commission staff will do so.

I have numbered the paragraphs in the Mayor's veto message attached, and will use the numbers as reference points.

**City's Credit Rating Issue**

In paragraph 6 on page 3 of the veto message, the Mayor states "Yesterday Moody downgraded the city's credit rating because of Council's actions. This type of financial irresponsibility must not be allowed to happen. Standard and Poors and Fitch are waiting in the wings to downgrade the city's credit rating if we continue this path".

City Council, I find this statement by Mayor Kilpatrick disingenuous, misleading, and harmful. The Mayor makes it seems as though Council's actions alone is the reason for the downgrade. But, this is far from the truth.

I would like to quote directly from Moody's recent credit report for the reason of the downgrade. A copy of the report is attached. The third paragraph on page 2 under the Opinion section states:

> "The downgrade and assignment of Baa3 (from Baa2) (GOULT) (stands for General Obligation Unlimited Tax bonds) and Ba1 (from Baa3) (GOLT) (stands for General Obligation Limited Tax bonds) ratings reflect the city's significant negative General Fund balances, delayed financial reporting, and a struggling economy. Persistent economic challenges that have

> impacted the state of Michigan, particularly the local economy, are exemplified by declining population, high unemployment levels and contracting housing market; the resulting revenue pressures which have led to past operating deficits and use of short-term borrowing for cash flow purposes which is expected to continue for the near-term; and leveraged debt profile. The rating distinction between the limited and unlimited tax bonds reflects the stronger security provided by the unlimited ad valorem property tax pledge".

There is **no** reference to Council's actions in the above paragraph. In fact, nowhere in Moody's credit report are the words "City Council actions" are used.

The only sentence remotely referring to Council's actions is located in the fourth paragraph of page 2 of Moody's report, which says, "The sale of the tunnel between the city and the city of Windsor for an estimated $75 million has been delayed repeatedly". But to the average reader, it is not known that Council delayed action on the tunnel deal, and why.

Of course, the tunnel deal for the second year in a row has died because the Mayor has failed to bring a full set of actionable documents to the Council for consideration. Furthermore, City Council could not live up to its fiduciary responsibility by approving the tunnel deal this year without having a clear understanding of the financial terms and documents associated with the proposed $75 million loan from the Province of Ontario to finance the deal. Moreover, the Council had legitimate concerns about the structure of the so-called "Detroit Tunnel Authority" and the autonomous power such authority would have when established to own and operate the Detroit half of the Detroit-Windsor tunnel under the deal. Lastly, many Council members are still just plainly opposed to selling a major City asset for a one-time revenue shot to balance the budget. Because of your Honorable Body's unreadiness with the tunnel deal, again after the Mayor had a year to provide a full set of documents for your consideration, you wisely elected not to assume any proceeds from the deal in the budget, and used fiscal stabilization bonds to help keep the budget whole.

Without question, Council's "back were against the wall" in having to again for the second budget season deny the tunnel deal, and painstakingly create a prior year deficit account and fiscal stabilization bonds to help keep the budget intact. Council is well aware that fiscal stabilization bonds is not an ideal solution as well, and once sold, could be fairly expensive with high interest rates. But Council had no choice given the ineptness of the Mayor's tunnel deal proposal. Cautiously, Council did include language in its closing resolution for the 2008-09 budget process indicating that the Body would consider taking out the fiscal stabilization bonds if the Mayor provided proper documentation supporting the deal and the deal made economic sense, and thereby, reduce the prior year deficit account.

But most importantly, Moody's recent downgrade was not directly tied to Council's actions on the budget.

And, I want to remind your Honorable Body that the rating agencies did not downgrade the City's ratings this past December, even though, Council put fiscal stabilization bonds in the budget last year.

**Lateness of the 2006 CAFR Issue**

In paragraph 7 of page 3 of the veto message, the Mayor stated, "This is not the first time Council has been irresponsible in handling budget matters. Two years ago this body allowed the contract for the city's outside auditors audit to sit until November 2006, putting the city months behind in fulfilling its audit requirements to the state. This single act put the city two years behind in preparing financial statement audits and has resulted in the state withholding revenue sharing on at least two different occasions because of Council's in-action. The city is still suffering from the effects of that decision".

I cannot believe the Mayor had the audacity to make this comment, and it is unfair to your Honorable Body. The Administration has yet to quantify how long Council "sat" on this contract. I have been working with City Council for 20 years, and usually Council withholds a contract because it is doing its due diligence regarding the contract.

In addition, a few months ago, before the budget process, Mayor Kilpatrick came before City Council basically blaming the external auditors, KPMG, for the lateness of the audit. But when the KPMG contract extension to complete the 2006 CAFR audit came before your Honorable Body a couple months later, the Council understood more that the 2006 CAFR audit was delayed because of mismanagement on Finance's part (prior to Norman White's, the current chief financial officer's tenure), lack of Finance personnel, and growing complexity of the CAFR audit process. Council will also recall that the external auditors cited an unprecedented 22 reportable conditions on the City's internal control system, which undoubtedly elongated the 2006 CAFR audit process.

To basically blame the Council for the lateness of the 2006 CAFR audit is just plain wrong.

**$300 Million Structural Deficit Issue**

In the first paragraph on page 1 of the veto message, the Mayor states, "When I took office in 2002 the city was faced with a 300 million dollars mounting structural deficit, which, if left unabated, would have plunged the city into receivership".

I have yet to understand the mounting $300 million shortfall when Mayor Kilpatrick took office. As I recall, Mayor Archer during his last term instituted departmental cuts in 2001-02. For fairness sake, I do recall the Kilpatrick administration continuing cut programs on its own during the initial stages of his administration, and the 2001-02 budget ended up with a $1.5 million surplus.

But, at the end of Mayor Kilpatrick's first budget year, the 2002-03 budget ended up with a $69 million budget deficit. Ironically, the Mayor, with Council's approval, issued $61 million in fiscal stabilization bonds, and fully depleted the City's rainy day fund by $8.5 million, to eradicate the budget deficit.

**Conclusion**

Your Honorable Body, on other minor points, I could continue to critique the Mayor's veto message on Council's budget actions regarding the Mayor's proposed 2008-09 budget. But I thought it was important to focus on and respond to critical issues in his veto message, namely, the City's credit rating, the lateness of the 2006 audit, and the alleged $300 million structural deficit.

As your Honorable Body knows, I have not always supported Mayor Kilpatrick's budgetary initiatives, and I have been very critical at times. But I believe I have support many of his initiatives as well. At any rate, I will continue to work long hours to provide the Council objective analysis on the Mayor's budgetary and financial initiatives for the good of our beloved City.

But in my humble professional opinion, to place unmerited blame on the City Council for some of the financial challenges faced by the City is unfair and warranted a strong response.

Attachments

cc: Council Divisions
Auditor General's Office
Ombudsperson's Office
Mayor Kwame M. Kilpatrick
Anthony Adams, Deputy Mayor
Pamela Scales, Budget Director
Norman White, Chief Financial Officer
Kerwin Wimberly, Mayor's Office

KWAME M. KILPATRICK, MAYOR
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May 30, 2008

Detroit City Council
Coleman A. Young Municipal Center
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Detroit, Michigan 48226

Honorable City Council:

1. Over the last seven years we worked together to restructure the city's budget in ways that have never been considered. When I took office in 2002 the city was faced with a 300 million dollars mounting structural deficit, which, if left unabated, would have plunged the city into receivership. The city was faced with a "Hobson's Choice" of either continuing to do business the way it has done in the past, or create a new world order to change the paradigm on how we approach problems, determine solutions, and execute a plan of action.

2. In spite of a stagnant state economy, local companies facing increased competition from the globalization of the world economy, cuts in Federal and State revenue sharing, and the worst economic climate in Michigan since the "Great Depression" we established an aggressive plan of action aimed at creating the "Next Detroit". That term embodies what we believe to be the hope of the citizens of this city to redefine what we are, not continue to hold on to what we were, and old ways of thinking. We rolled up our sleeves, began the difficult task of reshaping our workforce, service delivery models and thought processes on what could be accomplished. This was done in a business like fashion. Facing a down grade in the city's credit from all of the nation's rating agencies in 2005, we took the road less traveled and changed how we viewed the city and its operation to focus on the best way to deliver service to our residents and reduce our operating cost. We did the following:

- a. Changed the structural nature of health and benefits received by city employees that has resulted in substantial savings on an ongoing basis.
- b. Eliminated 100 million dollars in gross payroll.
- c. Reduced the dollar amount for outside contract services that the city enters into.

d. • Reduced overtime dramatically over the last five years.

e. • Consolidated real estate leases to save an estimated 40 million dollars on an ongoing basis.

f. • Dramatically reduced the amount of property that the city had to maintain through aggressive sale of non-productive land.

g. • Spun off operations of the Detroit Zoo, Historical Museum, and Eastern Market to reduce city's commitment to these entities and create an independent funding model for them to carry forward into the future.

h. • Transferred operation of the Southfield "Waste Transfer Station" to the Greater Detroit Resource Recovery Authority, which dramatically reduced internal cost to handle trash in the city of Detroit.

i. • Created a General Services Service Department to consolidate internal operations of city departments to provide greater efficiency.

j. • Created 74 million dollars in additional revenue by instituting a "Trash Fee" to cover the cost of handling and disposing of solid waste.

k. • Consolidated police precincts into districts, placing more officers on the street, reducing officers used in administrative capacities, and providing for greater flexibility in the operations of the police department.

3. Now, as we stand on the cusp of a balanced budget, we must avoid the temptation to return to old school thinking to balance the budget, which rejects innovative out of the box thinking in how a municipality deals with its assets. We can not retreat from the progress we have made to eliminate the city's structural deficit.

4. To this end I am vetoing the following items in Council's budget: Prior Year Deficit of $78 million, Fiscal stabilization bonds of $78 million, the whole block grant schedule, Charles H. Wright Museum of African American History ("MAAH") $2 million appropriation, City Council budget for $250,000 for lawyers to pursue proceedings against the Mayor's office and to balance I am vetoing the reduction in police turnover $1 million and Property Sales of $1.25 million. (Schedules A and B attached.)

5. First, let me address the use of Fiscal Stabilization Bonds or "Deficit Financing Bonds." These bonds by statute address short terms needs of a municipality to get it through difficult times. These bonds are more expensive than short term

borrowing for Revenue or Tax Anticipation Notes ("Rans and Tans" respectively) that the city issues every years. By borrowing sixty-five million dollars in fiscal stabilization bonds, the city is actually borrowing $78 million dollars with interest, reducing flexibility in next year's budget. When you examine the five-year trend in the city's budget projection you see that this type of borrowing accomplishes the exact opposite of what council intends: it destabilizes the city's financial condition. That for sure is not the way to go.

6. During Council's deliberation on the budget and proposed use of budget stabilization bonds Moody's rating service indicated that it would downgrade the city's credit rating. We advised Moody's that their action was premature because this administration would not use deficit borrowing to fill any budget gaps. We advised Moody's that we would make adjustments in the city's workforce, reduce spending, and sell unproductive land to compensate for whatever shortfall that may exist in this year's budget if we are not able to get a tunnel deal done. Yesterday Moody downgraded the city's credit rating because of Council's actions. This type of financial irresponsibility must not be allowed to happen. Standard and Poors and Fitch are waiting in the wings to downgrade the city's credit rating if we continue this path.

7. This is not the first time Council has been irresponsible in handling budget matters. Two years ago this body allowed the contract for the city's outside auditors audit to sit until November 2006, putting the city months behind in fulfilling its audit requirements to the state. This single act put the city two years behind in preparing financial statement audits and has resulted in the state withholding revenue sharing on at least two different occasions because of Council's in-action. The city is still suffering from the effects of that decision.

8. Now this body has proposed to issue deficit bonds because it doesn't want to act on an innovative way to eliminate the last vestiges of a 300 million dollars structural deficit. Borrowing to solve the problem is not the answer. That approach has never worked. This administration will not engage in deficit spending nor explore any option "Robbing Peter to pay Paul" in an attempt to avoid tough decision-making. Relying on the landmark decision granting power to Mayor Coleman A. Young in the <u>Stecher</u> decision when a previous council acted irresponsibly in trying to force bad budget decisions on the administration we will make the necessary adjustments in next year's budget if we are not able to get the tunnel deal done. Deputy Mayor Anthony Adams has already begun the process of determining what cuts, changes, modifications and alterations will be necessary if we don't get the tunnel deal done by June 31, 2008.

9. The discourse about the tunnel deal is disconcerting. Either there is a fundamental misunderstanding of how an appointive board operates, or a

fundamental misunderstanding of high finance. Either way, it's frightening. What council was ask to do was create an authority comprised of appointees of both the Mayor and Council to oversee an asset that we would receive seventy-five million dollars for, net sixty five million dollars, to the city's general fund. We currently receive roughly $400,000 dollars a year in revenue from the tunnel. That represents approximately .028% of the city's revenue in any given year, which does very little to help the city balance its budget. It is the proverbial "drop in the bucket". We were able to negotiate a deal, which by all standards is in line with appraisals and established value for the tunnel—get money for the city's general fund and still maintain oversight for the asset and eliminate our structural deficit. We see nothing wrong in this approach.

Using the city of Chicago as a guidepost and what they did to securitize revenue from their toll way we actually improved upon their model. Chicago
10. ceded authority over operation of its toll way to a private operator and took the money and ran. Here, the city grants control to a public board, gets money for its general fund, has no liability associated with the operation of the tunnel in the event of a revenue shortfall, and benefits from upside in any revenue generated from its operation. That is smart, innovative thinking, which eliminates the need to deficit borrow. Non-productive assets such as the tunnel need to be put to productive use. That's what the tunnel deal does. Lets not be afraid to "think outside the box"; let's not be blinded by a political agenda which rejects all that is different and new because it comes from the Messenger. Look at the message: Eliminate the last vestige of a 300 million dollar structural deficit.

Next, let me address the issue of my vetoing the block Grant Schedule. The idea of the Mayor and the Planning and Development Department (P&DD)
11. allocating CDBG funding is not new. Since the inception of the CDBG grant program in Detroit (in 1974), Mayor Coleman A. Young allocated the bulk of CDBG funding to "bricks and mortar" type activities. In 1976, using the 10% contingency line item, $506,000 dollars was set-aside (through Council Resolution) for the Neighborhood Opportunity Fund. Under subsequent administrations the NOF has been allowed to grow to its current unwieldy size. This unwieldy bureaucracy is also hampered by the imprudent act of funding up to the public service cap. While there is an allowable 15 percent cap on Public Service activities, there is not a mandate to spend up to and in recent years over the cap creating a backlog of projects that cannot go to contract.

In 2002-2003 P&DD began a major "Restructuring" of the CDBG process.
12. The thrust of the initiative featured targeting to clusters through specific activities needed in those areas. In 2004-2005 those specific activities, identified in prior years, became categories. In 2004-2005 Categories were introduced and were approved by City Council. The groups were named by the Mayor. Since

that time, "Broad Categories" have been provided through the budget process every year. However, after the 2004-2005 fiscal year, City Council has voted groups into the budget against the City Charter. According to the April 17, 2008 legal opinion of the City of Detroit Law Department, "Based upon the above authority, [the City Charter] it is our opinion that City Council appropriation of a line item budget, through the naming of specific subrecipient groups, for Community Development Block Grant funds and Neighborhood Opportunity Funds is a violation of Section 8-205 of the 1997 Detroit City Charter. Instead, the naming of such groups is the responsibility and prerogative of the Executive Branch through its Planning and Development Department."

13. I contend that City Council was not blind sided by some new phenomenon, or "ill conceived effort", but by a P&DD effort to set the process right.

14. P&DD has also continually asserted the need to address HUD's concerns cited in its 2003 Monitoring findings and more recently through end of year evaluations as shown briefly below:

15. In HUD's 2003 monitoring report HUD officials suggested improving our CDBG process in four ways. Implementing these HUD directives will prevent the possibility of HUD reducing our CDBG allocation for non-performance:

1. "Make the Consolidated Plan a Meaningful Planning and Implementation Tool and only fund projects, which directly address the goals of the City's Consolidated Plan.

2. Activities should be concentrated so that there are visible and sustainable results."

3. "Spend HUD funds to achieve demonstrable results and give priority to projects, which address the needs and goals of the Consolidated Plan.

4. "Reduce the number of projects/activities funded annually."

16. Since 2003 the administration has proposed changes in the City of Detroit's CDBG allocation process based on these HUD directives.

17. The Administration proposed to address these HUD directives by creating funding categories tailored to the Consolidated Plan. Our current process is driven by each organization's own immediate needs rather than an investment strategy developed by City elected officials with analytical support by their staff and input from the community. The CDBG proposal process—involving the combined efforts of the Mayor, Council, CPC, and Planning and Development

Department (P&DD) staff, could be used to develop a Detroit community investment strategy (based on Consolidated Plan goals). The strategy should be used as the basis for the City's CDBG funding allocations.

P&DD has focused on the needs identified in the 5-Year Strategy by
18 allocating funds to the eligible activity categories that are needed to assist in the redevelopment of the City rather than focusing on individual sponsoring organizations.

A meaningful dialog between City Council and the Administration is promised
19. by City Council every year; as is indicated in this year's budget, but with few results that directly address many of HUD's concerns. Interactions with City Council have resulted in joint threshold and selection criteria. The joint criteria resulted in a re-issuance of CDBG proposals despite our objections to use other less costly and time-consuming solutions. Additionally, in an effort to work cooperatively, P&DD recently reprogrammed funds that City Council assigned to the wrong activity.

This year the Council allowed its staff (City Planning Commission) to allocate funding to groups based on Council priorities and then over rode their decisions
20. by allowing 14 groups back into the funding pool. This action results in staff being moved from the public service activity, where they logically should be funded, to an activity that is inappropriate based on HUD requirements. In addition, City Council has continued to initiate programs over the years that have resulted in unspent funds that were recently reprogrammed by the Administration to fight Lead Hazards in the City of Detroit. Over a million dollars remain unspent in Council programs initiated without the input of P&DD. We agree that "a constructive discussion of modifications to the City CDBG/NOF program beginning this June", should occur. We also agree that HUD sees us as one City and we should work cooperatively and transparently toward the enhancement of this program, however, this cannot occur when, for example, City Council engages HUD in a dialogue regarding the CDBG process without P&DD knowledge or input until after the fact.

Categorical funding will streamline program administration and allow us to
21. have greater impact on critical services that our residents need. For years we have parceled out dollars to many organizations, which attempt to deliver service. This scattered service delivery model does not lend itself to creating "cooperative ventures" between organizations. It perpetuates a silo mentality because each organization competes for scare resources, not focusing on the broader mission on how they can provide service by working with others. Recently large philanthropic organizations have turned to a more cooperative model, reducing the number of agencies they fund to better direct scare

resources to service delivery. We must follow suit, and thus the reasons for my veto.

With respect to the Charles H. Wright Museum of African American History
22. ("MAAH"), the $2 million increase in their subsidy doubles their current operating subsidy from the city. This is more operational money than the city has ever given them and more than they asked for. The MAAH has struggled in the past but is starting to stabilize their finances by increasing private contributions and membership. That is the way towards self-sufficiency. The reason for spinning off the DIA, Historical and not having MAAH a city department was to allow them to function as museum's do. They cannot survive if they are that dependent on the city for financial support. In tough times they get cut with short notice and no recourse. Independence is crucial for their own survival. Plus, this change would be an additional operational, long-term cost on the general fund that outstrips their ability to fund raise. At a time when we are balancing our operational budget these types of increases pushes us backwards. We are adding things that we cannot support long term when they have other options.

I would also be remiss if I didn't comment on the use of Real estate sales to
23. eliminate the city's structural deficit. Real estate sales always represent a "bug-a-boo" to some members of council because they are concerned that we are selling off assets. When you examine the city's current real estate portfolio, if would take this administration and the next proceeding administrations years to sell off all that we own. While we have never advocated selling everything I note that we gave you a package of real estate sales more than 20 million over this year's budget to create budget relief in next fiscal year. I will never discourage opportunity purchases which, in this instance, aid in the construction of a new addition to Children's Hospital of Michigan ("Tolan" Field"), allow the city to stay in compliance with dwsd consent decrees regarding our operation of the water and sewage system ("Blain, Riverside Park, Revere Cooper and Brass"), or eliminate vacant buildings that the city has to maintain (' Broadhead Armory, GAR Building, Stone Pool). That makes good business sense.

Finally, a word about Economic Stimulus Package. This package is designed
24. to enhance the city's aging infrastructure and stimulate growth and development in the local economy, create entrepreneurial loan fund and a rainy day fund balance. Under the current method of funding capital projects it would take the city more than 15 years to fund all of the capital projects listed in the package. By consolidating these projects into a stimulus plan we would be able to accomplish several things: employ Detroit companies at a time when there is a general slow down in the local economy, employ Detroiters who needs jobs during this time, redevelop numerous municipality facilities to upgrade, create better work environments and reduce our operational costs, consolidate

operations to provide greater efficiencies and service to our residents. My travels around the city have revealed a great deal of interest from city residents who understand the need to improve the quality of the city's facilities, create new businesses to employ Detroiters, and the need to crate a rainy day fund for the city. The fact that Greektown filed for bankruptcy doesn't impact the feasibility of the financial structure. Our market analysis took into account the possibility of Casino failure. We will be forwarding to you updated feasibility books on Monday, June 2, 2008, and look forward for the opportunity to have a full discussion of the merits of the stimulus package.

Sincerely,

Kwame M. Kilpatrick
Mayor

Attachment(s)

Cc: Deputy Mayor
Anthony Adams

Chief Financial Officer
Norman White

Budget Director
Pamela Scales

Chief of Staff
Kandia Milton

Moody's Investors Service



New Issue: Detroit (City of) MI

## MOODY'S DOWNGRADES RATING TO Baa3 FROM Baa2 ON THE CITY OF DETROIT'S (MI) OUTSTANDING GOULT DEBT AND DOWNGRADES RATING TO Ba1 FROM Baa3 ON CITY'S OUTSTANDING GOLT DEBT; ASSIGNS STABLE OUTLOOK

### ASSIGNS Baa3 / STABLE OUTLOOK TO CITY'S GOULT BONDS, SERIES 2008-A AND 2008-B AND Ba1/ STABLE OUTLOOK TO CITY'S GOLT BONDS, SERIES 2008-A(1) AND SERIES 2008-A(2)

Municipality
MI

**Moody's Rating**

| ISSUE | | RATING |
|---|---|---|
| General Obligation Bonds (Unlimited Tax), Series 2008 -A | | Baa3 |
| **Sale Amount** | $56,225,000 | |
| **Expected Sale Date** | 05/29/08 | |
| **Rating Description** | General Obligation | |
| General Obilgation Refunding Bonds (Unlimited Tax), Series 2008-B | | Baa3 |
| **Sale Amount** | $56,215,000 | |
| **Expected Sale Date** | 05/29/08 | |
| **Rating Description** | General Obligation | |
| General Obligation Capital Improvement Bonds (Limited Tax), Series 2008 -A(2) (Taxable) | | Ba1 |
| **Sale Amount** | $25,000,000 | |
| **Expected Sale Date** | 05/29/08 | |
| **Rating Description** | General Obligation Limited Tax | |
| General Obligation Capital Improvement Bonds (Limited Tax), Series 2008 -A(1) | | Ba1 |
| **Sale Amount** | $46,690,000 | |
| **Expected Sale Date** | 05/29/08 | |
| **Rating Description** | General Obligation Limited Tax | |

**Opinion**

1. NEW YORK, May 29, 2008 -- Moody's Investors Service assigns a Baa3 rating and stable outlook to the City of Detroit's $56.255 million General Obligation Bonds (Unlimited Tax), Series 2008-A and to the city's $56.215 million Refunding Bonds (Unlimited Tax), Series 2008-B. Moody's also assigns a Ba1 rating and stable outlook to the city's $46.69 million General Obligation Capital Improvement Bonds, (Limited Tax), Series 2008-A(1) and to the city's $25 million General Obligation Capital Improvement Bonds (Limited Tax) Series 2008-A(2) (Taxable). Concurrently, Moody's has downgraded the rating to Baa3 from Baa2 on the city's outstanding debt secured by the city's general obligation unlimited tax pledge and has downgraded the rating to Ba1 from Baa3 on the city's outstanding debt secured by the city's general obligation limited tax pledge. Moody's has also downgraded the rating to Baa3 from Baa2 on the Detroit Retirement Systems Funding Trust 2005's Taxable Certificates of Participation, Series 2005 A and B and on the Detroit Retirement Systems Funding Trust 2006's Taxable Certificates of Participation, Series 2006 A and B. The Certificates are secured by the city's unconditional contractual obligation to pay debt service, which is not subject to annual appropriation.

2. The Series 2008 Unlimited Tax Bonds are secured by the city's general obligation unlimited tax pledge. Proceeds of the Series 2008-A Bonds will finance various capital projects throughout the city while proceeds of the Series 2008-B Bonds will refund portions of the city's outstanding Series 1996B Refunding Bonds, Series 1997A Bonds, Series 1997B Refunding Bonds, and Series 1999A Bonds for an estimated net present value savings. The Series 2008 Limited Tax Bonds are secured by the city's general obligation limited tax pledge. Proceeds of the Series 2008-A(1) Bonds will finance the acquisition of various vehicles and equipment and proceeds of the Series 2008-A(2) Bonds will finance a portion of the cost of certain real and

personal property for use by the city.

3. The downgrade and assignment of Baa3 (GOULT) and Ba1 (GOLT) ratings reflect the city's significant negative General Fund balances, delayed financial reporting, and a struggling economy. Persistent economic challenges that have impacted the state of Michigan, and particularly the local economy, are exemplified by declining population, high unemployment levels and contracting housing market; the resulting revenue pressures which have led to past operating deficits and use of short-term borrowing for cashflow purposes which is expected to continue for the near-term; and leveraged debt profile. The rating distinction between the limited and unlimited tax bonds reflects the stronger security provided by the unlimited ad valorem property tax pledge. Moody's assignment of the stable outlook reflects our expectation that the city's credit quality will neither significantly improve nor significantly deteriorate in the near term.

DEFICIT FINANCIAL POSITION CONTINUES TO CHALLENGE MANAGEMENT

4. From fiscal 1999 through audited fiscal 2006, the city has recorded operating deficits, decreasing the General Fund balance from $206 million, or 13% of General Fund revenue, as recently as fiscal 2002, to deficit $107.2 million (or -7.2%of General Fund revenues) in fiscal 2006. Highlighting the stress, the unreserved, undesignated General Fund balance remained in a deficit position of negative $174 million, or a -11.7% of General Fund revenue at the end of fiscal 2006. Between fiscal 2002 and fiscal 2006, General Fund expenditure growth exceeded revenue growth annually (or expenditure reductions have been less than revenue shortfalls) creating an annual structural imbalance.

5. While overall General Fund revenues have increased from $1.375 billion in fiscal 2004 to $1.4 billion in fiscal 2006 (before transfers), two of the city's largest General Fund revenue streams have been pressured, distributable state aid and municipal income taxes. Distributable state aid, 19% of fiscal 2006 General Fund revenue, has been reduced, falling from a high of $333.8 million in fiscal 2002 to $279.5 million in fiscal 2006. This line-item is budgeted for further reductions in fiscal 2007 and fiscal 2008. Reflecting ongoing economic weakness (unemployment was 14.7% in March 2008), municipal income tax receipts, 19% of fiscal 2006 General Fund revenue, have declined since 2002. Recognizing the employment realities, the city budgeted for declining income tax receipts in fiscal 2007. Other revenue streams, most notably wagering taxes, have grown. Casino wagering taxes and fees increased from $109 million in fiscal 2002 to $157 million in fiscal 2006. Significantly, some revenue pressures are likely to continue, challenging city officials by limiting options to restore necessary structural balance to essentially expenditure-side solutions.

6. The city has implemented a variety of one-time revenues to build reserves as well as made organizational changes to regain structural balance over the last several fiscal years. Actions reportedly implemented include sale of assets, personal property tax audit, switching to a garbage collection fee from a property tax millage, savings from the pension refinancing, department-wide cuts and layoffs, and salary and healthcare concessions. However, some of these were offset by some unfavorable variances (including one-time costs associated with the layoffs and health care concessions not being achieved when budgeted). Overall the city's General Fund expenditures decreased from $1.577 billion in fiscal 2004 to $1.41 billion in fiscal 2006 (before transfers). The sale of the tunnel between the city and the city of Windsor for an estimated $75 million has been delayed repeatedly. The 2008 budget includes the sale of land of between $22 and $30 million to the city's Water Department.

DELAYED FISCAL 2006, FISCAL 2007 AND FISCAL 2008 FINANCIAL REPORTING

7. The release of the city's fiscal 2006 audited financial statement was significantly delayed. Due to be published no later that six months after the close of the fiscal year on June 30th per state law, the final statement was published 14 months late in February, 2008. The fiscal 2006 audit included an unqualified independent auditors' report with exception to a reference to the unaudited financial statements of the Detroit Public Library. The auditors also provided the city with a second document which noted certain "Reportable Conditions" involving the city's internal control over financial reporting and operations including 22 conditions it considered material. Officials report that the city has developed and have begun executing plans to address the concerns identified. Also as provided by state law, the State of Michigan withheld a portion of the city's state shared revenues payments in December 2007 and February 2008 due to the delayed publishing of the audited financial statement.

8. The final audited financial statements for fiscal 2007 are also delayed and are expected in November 2008. Officials estimate that the city ended the fiscal year with an unreserved General Fund deficit of $123 million. Audited financial statements for fiscal 2008 are expected in May 2009. After appropriating an $88.6 million carry-over operating deficit as an expense, the proposed fiscal 2008 Budget would eliminate the deficit position in the undesignated General Fund balance. The proposed budget includes several initiatives including additional revenues due to land sales, pension credit and the tunnel securitization. Audited financial statements for fiscal 2009 are expected to be published on time. While Moody's believes that the standing initiatives are reasonable, considerable challenges remain and the city's ability to publish audited financial statements on schedule, maintain structural balance and build reserves will continue to be a focus of credit reviews. Further exacerbating Detroit's local challenges, the state's financial condition remains pressured.

ECONOMIC REDEVELOPMENT EFFORTS CONTINUE; WEAK DEMOGRAPHIC TRENDS PERSIST

9. The City of Detroit's economic revitalization efforts, which started in the mid-1990s, continues to show signs of progress albeit modest in the face of the overall economic profile. Despite regional challenges, some economic development in the city has been notable. Capital commitments and economic incentives, such as federal empowerment zone and state renaissance zone designations, have assisted in job development and increased downtown and riverfront economic activity. Major developments underway include the expansion of several major healthcare providers in the city including Henry Ford Hospital and St. John Hospital and Medical Center, Marathon Petroleum's expansion of its Southeast Detroit Refinery, and the restoration of the Book Cadillac Hotel. In addition, the city's three casinos continue to build, with both the Motor City and MGM Grand casinos opening new hotel and casino complexes in late 2007, providing a growing revenue source for the city. The casinos, hotels and an expanding healthcare sector are important, as they provide a measure of diversity to the historically automotive manufacturing concentrated tax base. Nevertheless, the challenges of the corporate domestic auto manufacturing sector continue. While Detroit is home primarily to research and development and non-manufacturing jobs, the economy remains vulnerable to this sector. Both Chrysler (Senior Unsecured rated A3), the city's top tax payer at 7.6% of the city's taxable valuation, and General Motors (Senior Unsecured rated Caa1), the city's third largest taxpayer at 3.5% of the city's taxable valuation, continue to remain a large presence within the city.

10. Despite some positive developments and diversification of Detroit's economy, the city's economic and demographic profile remains one of the weakest in the nation. Net migration is negative and the city's population continues to decline, in contrast to that of counties surrounding Detroit. Over the past five decades, Detroit's population has fallen by nearly in half. Despite a labor force which has declined from 633,000 (in 1980) to 322,215 (June 2006), unemployment levels have remained persistently high (14.7% in March 2008, compared to 7.9% state and 5.2% national rates). Since 1980, the city's lowest annual unemployment figure was 6.6%, achieved in 2000, compared to 3.6% state and 4.0% nationally that same year. Moody's believes that the domestic auto industry struggles will spill over into other sectors of the economy. Evidence of economic challenge is also found in the metro area's rate of home foreclosures which is among the highest in the country and poverty rates that persist at rates more than twice the state average. Wealth indicators have generally declined since 1970 (per capita income was 95% of the state average), compared to the 2000 census (PCI equaled 66.4% of the state average).

HIGH DEBT BURDEN; MORE BORROWING FOR CASH FLOW EXPECTED

11. When considering the city's general obligation debt only, the city's debt burden is high at 8.8% (direct debt burden is 3.3%). Favorably, general obligation limited tax debt has remained relatively flat in recent years with an aggressive amortization schedule through fiscal 2009. This could provide for some operating relief, as the limited tax debt effectively competes (on a first lien basis) with operating expenditures. The city has issued both Revenue Anticipation Notes (RANs) and Tax Anticipation Notes (TANs) for cash flow purposes in fiscal 2006 through fiscal 2008. While the city paid off its borrowings for fiscal 2008 in March, 2008, the city expects to issue a total of $125 million in RANs and TANs in June 2008 to support cashflow in fiscal 2009.

12. The Detroit Retirement Systems Funding Trust 2005 and Detroit Retirement Systems Funding Trust 2006 issued Certificates of Participation (COP) to fund the city's unfunded accrued actuarial liability for its pension systems. The Certificates are payable solely from all COP Service Payments, pursuant to Service Contracts with the city. The city's unconditional obligation to pay all COP Service Payments is contractual, and not subject to appropriation. Should an event of insufficient payment on the COP's occur, the courts can compel the city to raise the payment of any judgment through the levy of taxes, which would not be limited as to rate or amount. The certificates are floating rate notes for which the city pays an adjustable interest rate tied to the LIBOR index to bondholders and for which there is no put option. When accounting for the recent issuance of $1.44 billion pension COP's, the debt burden increases to 14.1%, but reflects the shift from UAAL to fixed obligations outstanding. Debt amortization drops to 35.8% in ten years when accounting for the amortization schedules of the city's debt general obligation, debt secured by revenues and the outstanding pension COP's.

13. In conjunction with the issuance of the certificates, the City of Detroit entered into floating to fixed rate insured swap agreements with UBS AG (Senior Unsecured rated Aa1) and Siebert, Brandford, Shank & Co. Together, as of March 31, 2008, the combined mark-to-market valuation on the COP swap agreements is approximately $151 million payable to counterparties upon termination. The swap payments are currently insured by XL Capital Assurance Inc. (financial strength rating A3/review for possible downgrade) and Financial Guaranty Insurance Co. (financial strength rating Baa3/review for possible downgrade). The swap agreements allow the counterparty to terminate the agreement early upon the system's rating of the COP debt being withdrawn, suspended or downgraded below Baa3 (or equivalent) by one of two rating agencies when the swap insurer's rating falls below an A3 (or equivalent) by one of two rating agencies.

**Outlook**

14. The credit outlook is stable, which reflects Moody's expectations that the city's credit quality will neither significantly improve nor significantly deteriorate in the near term. The low ratings of Baa3 (GOULT) and Ba1 (GOLT) incorporate the city's ongoing economic and fiscal challenges and future credit reviews will focus on the city's ability to achieve its management initiatives, maintain structural balance and strength reserves through the mid-term.

WHAT COULD CHANGE THE RATING UP

- Material operating surpluses, achieved through financial structurally balanced solutions that will carry forward to future budgets

- Sustained economic improvement coupled with revenue enhancements

WHAT COULD CHANGE THE RATING DOWN

- Revenue challenges that continue to exceed expenditure (and alternate revenue) solutions

- Continued operating deficits leading to heightened cash-flow weakness

- Further increase of the city's leveraged position

- Economic performance which would be unable to sustain revenue growth or revenue stability

KEY STATISTICS:

Full valuation: $28.2 billion

Full value per capita: $32,403

Estimated 2006 population: 871,121 (8.4% decline from 2000)

Unemployment (3/08): 14.7% (compared to 7.9% state and 5.2% national rates)

Top three property tax payers as a % of total: 14.6%

Debt burden: 14.1% (includes pension COP's)

Fiscal 2006 General Fund balance: deficit $107.2 million (-7.2% of General Fund revenues)

Fiscal 2006 Undesignated General Fund balance: deficit $173.7 million (-11.7% of General Fund revenues)

Unaudited Fiscal 2007 Undesignated General Fund balance: deficit $123 million

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# Moody's Ratings System

## In Brief

### What is a rating?

*A rating is Moody's opinion of the ability and willingness of an issuer to make timely payments on a debt instrument, such as a bond, over the life of that instrument.*

### What a rating is not...

*Ratings are not recommendations to buy or sell, nor are they a guarantee that default will not occur.*

### How do the capital markets use ratings?

*Investors use ratings to help price the credit risk of fixed-income securities they may buy or sell. Many also use ratings as limits on their investment parameters and as means for expanding their investment horizons to markets or security types they do not cover by their own analysis. Because major investors globally rely on Moody's ratings, the ratings help to provide issuers of debt with stable, flexible access to those sources of capital.*

### What types of securities does Moody's rate?

*Any type of debt or related obligation of interest to institutional investors, e.g., bonds, debentures, asset-backed and mortgage-backed securities, convertible bonds, medium-term notes, derivative securities, etc. Moody's does not rate stocks, i.e., equities.*

### What do credit ratings measure?

*Ratings are a forecast or indicator of the potential for credit loss due to a failure to make payment, delay in payment, or partial payment to the investor. Credit loss is the difference between what the issuer has promised to pay and what is actually received. Moody's ratings measure total credit loss – including both the probability an issuer will default and the expected severity of loss after a default occurs.*

### What is Moody's rating process?

*The rating process:*

- *gathers information sufficient to evaluate risk to investors who might own or buy a given security,*
- *develops a conclusion in committee on the appropriate rating,*
- *monitors on an ongoing basis to determine whether the rating should be changed, and*
- *informs the marketplace and market participants of Moody's actions.*

### How does a Moody's rating committee work?

*Moody's ratings are initially determined or subsequently changed through committee. The lead analyst for a given company, industry, country, or asset type frames the discussion, including offering the rating recommendation and its rationale.*

*At minimum, the committee includes a managing director or other designated individual and the lead analyst. The committee may be expanded to include as many perspectives and disciplines as are needed to address all analytical issues relevant to the issuer and the security being rated.*

*Issues affecting the size of the committee may include the size of the issuer, complexity of the security, geography, or whether a transaction of the type has ever been done before. The discussions of the committees are strictly confidential, and only Moody's analysts may serve on a committee.*

### What sources of information do analysts use?

- *Publicly available data, e.g., annual reports.*
- *Prospectuses, offering circulars, offering memoranda, trust deeds, or indentures of particular securities.*
- *Market data, e.g., stock price trends, trading volume, data on bond price spreads.*
- *Economic data from industry groups, associations or bodies, such as the World Bank.*

**Moody's Investors Service**

- *Data from agencies, such as central banks, ministries, or regulators.*
- *Books or articles from academic sources, financial journals, news reports.*
- *Discussions with expert sources in industry, government, or academia.*
- *Data that may come from meetings or conversations with the debt issuer. If the data are confidential, Moody's strictly observes this.*

## How long has the rating system been in use?

*John Moody introduced ratings to the U.S. bond market in 1909 when he published the first debt ratings in his Manual of Railroad Securities.*

## How does the probability of default change as one moves down the rating scale?

*The historic default rate for Aaa-rated securities is very low. The average default rate from 1970-2005 for Aaa-rated securities over a 10-year period was only 0.56%, well under 1%. However, as one descends the rating scale into the speculative-grade section, the default rate increases dramatically. For B-rated securities, the 10-year probability of default is 46.12%.*

## Important definitions pertaining to the rating process:

- ***Rating outlooks:*** *These are opinions regarding the likely direction of an issuer's rating over the medium term. Rating outlooks fall into the following four categories: Positive, Negative, Stable, and Developing (Contingent upon an event),*
- ***Rating review/watchlist:*** *A credit is placed on the watchlist when it is on review for possible upgrade, or on review for possible downgrade, or (more rarely) on review with direction uncertain. Moody's will attempt to conclude a formal review within 60 days.*
- ***Confirmation of a rating:*** *If, after a formal review, a rating committee decides not to change a rating, the rating is said to be confirmed. Rating confirmations are entered in Moody's databases.*
- ***Affirmation of a rating:*** *An affirmation of a rating occurs without a review, and it does not involve a database entry. Affirmations may occur:*
  - *following an annual review*
  - *following the release of new information by the company*
  - *following a major market event (such as regulatory changes, a major acquisition, and/or market turbulence, etc.).*

*There may also be other special situations in which ratings are affirmed.*

## What is Moody's rating scale?

*The rating scale, running from a high of Aaa to a low of C, comprises 21 notches. It is divided into two sections, investment grade and speculative grade. The lowest investment-grade rating is Baa3. The highest speculative-grade rating is Ba1.*

**Long-term Debt Ratings** (maturities of one year or greater)

**Investment Grade**
**Aaa** – "gilt edged"
**Aa1**, **Aa2**, **Aa3** – high-grade
**A1**, **A2**, **A3** – upper-medium grade
**Baa1**, **Baa2**, **Baa3** – medium grade

**Speculative Grade**
**Ba1**, **Ba2**, **Ba3** – speculative elements
**B1**, **B2**, **B3** – lack characteristics of a desirable investment
**Caa1**, **Caa2**, **Caa3** – bonds of poor standing
**Ca** – highly speculative
**C** – lowest rating, extremely poor prospects of attaining any real investment standing

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**Short-Term Debt Ratings** (maturities of less than one year)

**Prime-1** (highest quality)
**Prime-2**
**Prime-3**
**Not Prime**

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**Speculative Grade Liquidity (SGL) Ratings** (assigned to speculative grade issuers that are by definition Not Prime)

**SGL-1** - very good
**SGL-2** - good
**SGL-3** - adequate
**SGL-4** - weak

## US Municipal and Tax-Exempt Ratings

Municipal Ratings are opinions of the investment quality of issuers and issues in the US municipal and tax-exempt markets. As such, these ratings incorporate Moody's assessment of the default probability and loss severity of these issuers and issues. The default and loss content for Moody's municipal long-term rating scale differs from Moody's general long-term rating scale. (Please refer to Corporate Equivalent Ratings under Policies and Procedures.)

Municipal Ratings are based upon the analysis of four primary factors relating to municipal finance: economy, debt, finances, and administration/management strategies. Each of the factors is evaluated individually and for its effect on the other factors in the context of the municipality's ability to repay its debt.

### Municipal Long-Term Rating Definitions:

**Aaa**

Issuers or issues rated Aaa demonstrate the strongest creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**Aa**

Issuers or issues rated Aa demonstrate very strong creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**A**

Issuers or issues rated A present above-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**Baa**

Issuers or issues rated Baa represent average creditworthiness relative to other US municipal or tax- exempt issuers or issues.

**Ba**

Issuers or issues rated Ba demonstrate below-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**B**

Issuers or issues rated B demonstrate weak creditworthiness relative to other US municipal or tax- exempt issuers or issues.

**Caa**

Issuers or issues rated Caa demonstrate very weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**Ca**

Issuers or issues rated Ca demonstrate extremely weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**C**

Issuers or issues rated C demonstrate the weakest creditworthiness relative to other US municipal or tax-exempt issuers or issues.

**Note:** Moody's appends numerical modifiers 1, 2, and 3 to each generic rating category from Aa through Caa. The modifier 1 indicates that the issuer or obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

## US Municipal Short-Term Debt And Demand Obligation Ratings

### Short-Term Debt Ratings

There are three rating categories for short-term municipal obligations that are considered investment grade. These ratings are designated as Municipal Investment Grade (MIG) and are divided into three levels -- MIG 1 through MIG 3. In addition, those short-term obligations that are of speculative quality are designated SG, or speculative grade. MIG ratings expire at the maturity of the obligation.

**MIG 1**

This designation denotes superior credit quality. Excellent protection is afforded by established cash flows, highly reliable liquidity support, or demonstrated broad-based access to the market for refinancing.

**MIG 2**

This designation denotes strong credit quality. Margins of protection are ample, although not as large as in the preceding group.

**MIG 3**

This designation denotes acceptable credit quality. Liquidity and cash-flow protection may be narrow, and market access for refinancing is likely to be less well-established.

**SG**

This designation denotes speculative-grade credit quality. Debt instruments in this category may lack sufficient margins of protection